Office of Chief Counsel Internal Revenue Service

memorandum

CC:LM:RFP:JAX:POSTF-153857-01 RWDillard

date: August 5, 2002

to: Internal Revenue Service, Examination Division (LMSB)

Attn: Revenue Agent John Alfson

from: Associate Area Counsel

(Retailers, Food, Pharmaceuticals & Health Care)

subject:

Advisory Opinion

ISSUES

- 1. Whether the taxpayer's acquisition of ("") qualifies as a reorganization under I.R.C. § 368.
- 2. How should the taxpayer determine its basis in the stock of immediately after the acquisition?

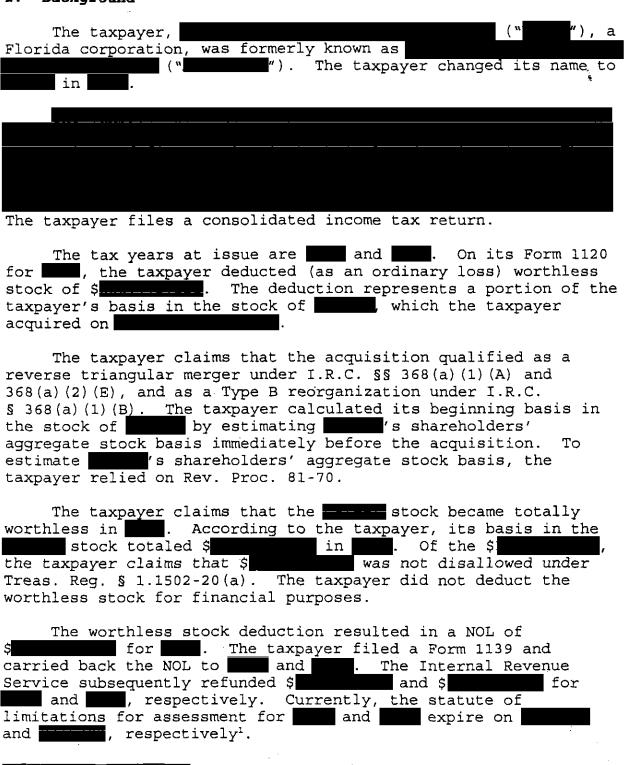
, (b)(5)(AC), (b)(7)a
, (b)(5)(AC), (b)(7)a

<u>CONCLUSIONS</u>

- 1. Yes. The acquisition qualifies as a reorganization under I.R.C. § 368(a)(1)(A) by reason of the application of § 368(a)(2)(E). The acquisition also qualifies as a reorganization under I.R.C. § 368(a)(1)(B).
- 2. The taxpayer can determine its initial basis in the stock of by choosing a basis equal to (1) so set asset basis just prior to the reorganization, or (2) shareholders' aggregate stock basis immediately before the reorganization.

FACTS

1. Background



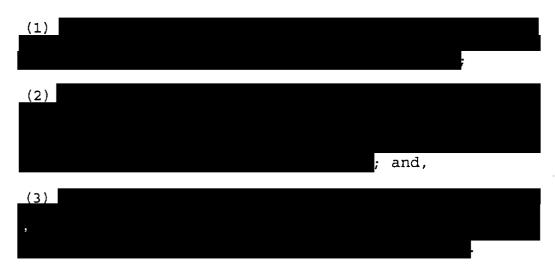
¹ For the and and tax years, however, any deficiency attributable to the net operating loss carryback can be assessed

2. Taxpayer's Acquisition of

On ______, the taxpayer entered into an Agreement and Plan of Merger ("the Agreement") with Sunrise Merger ("but owned"), a Delaware corporation and wholly owned subsidiary of the taxpayer, and _____, a Delaware corporation. The Agreement provided that the taxpayer would acquire _____, and its wholly owned subsidiaries through the merger of _____ with and into _____ (with _____ surviving the merger and becoming a wholly owned subsidiary of the taxpayer).

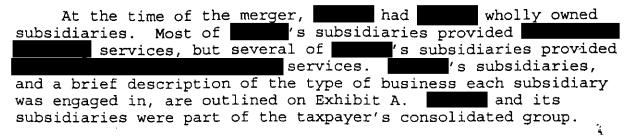
Just prior to the effective time of the merger, had shares of common stock outstanding. had no outstanding preferred stock. Additionally, the taxpayer had shares of common stock outstanding. The taxpayer had no outstanding preferred stock. The effective time of the merger was the date and time that a Certificate of Merger was filed with the Secretary of State of Delaware.

The Agreement provided that each corporation's stock would be converted as follows:



The taxpayer issued shares of its common stock to the shareholders. The taxpayer also paid cash to some shareholders in lieu of issuing fractional shares of its common stock. According to the taxpayer, its common stock had a fair market value of \$ on the effective date of the exchange,

prior to the expiration of the statute of limitations for assessment for . I.R.C. § 6501(h).



3. Zame 's Disposition of its Subsidiaries

Shortly after the acquisition, began to dispose of its subsidiaries. In the many merged of its subsidiaries into one of the taxpayer's wholly owned subsidiaries. Additionally, distributed the stock of its companies to the taxpayer.

In , the	taxpayer sold	all of its		
assets and busines	ses, and		' s	
subsidiaries, to			, a subsidi	ary of
	of	, for	,	
sale was part of a				
	business to	focus on more	e <u>profita</u> ble	
services and		services.	als	o sold
the assets of its			<u>sub</u> sidiarie	s to
		for \$. Final	ly,_
dissolved one of its subsidiaries,				
				<u> </u>

DISCUSSION

Issue 1

No gain or loss is recognized by a shareholder who, in pursuance of a plan of reorganization, surrenders his stock or securities in a corporation which is a party to a reorganization for stock or securities in such corporation or in another corporation which is a party to the reorganization. I.R.C. § 354(a)(1). Similarly, no gain or loss is recognized by a corporation if the corporation is a party to a reorganization and if it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation which is a party to a reorganization. I.R.C. § 361(a).

I.R.C. § 368 defines a reorganization, which can take several different forms. One type of reorganization is "a statutory merger." I.R.C. § 368(a)(1)(A). A statutory merger is one effected pursuant to the corporate laws of the United States, a State, a territory, or the District of Columbia. Treas. Reg. § 1.368-2(b)(1). As required under I.R.C. § 368(a)(1)(A), the

merger of _____, a Delaware corporation, into _____, another Delaware corporation, was effected pursuant to the laws of the State of Delaware.

Transactions qualifying as a reorganization under I.R.C. § 368(a)(1)(A) can take several different forms. One of the forms is a reverse triangular merger, which is a statutory merger that qualifies as a reorganization under I.R.C. § 368(a)(1)(A) 3 by reason of the application of I.R.C. § 368(a)(2)(E).

Under I.R.C. § 368(a)(2)(E), if certain conditions are satisfied, a transaction otherwise qualifying under I.R.C. § 368(a)(1)(A) is not disqualified by reason of the fact that stock of the controlling corporation, i.e. the corporation that was in control of the merged corporation before the merger, is used in the transaction. The conditions which must be satisfied under I.R.C. § 368(a)(2)(E) are:

- (1) after the merger, the surviving corporation must hold substantially all of its properties and the properties of the merged corporation; and,
- (2) in the transaction, the former shareholders of the surviving corporation must exchange an amount of stock in the surviving corporation (which constitutes control of the surviving corporation) for an amount of stock in the controlling corporation.

Control is defined as 80 percent of the combined voting power and 80 percent of the number of all classes of stock of the corporation. I.R.C. § 368(c).

In this case, the statutory requirements under I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(E) were satisfied. After the merger, owned all of its properties and the properties owned by Additionally, the former shareholders of exchanged all of their stock in for stock in the taxpayer.

The taxpayer's acquisition of also satisfied the statutory requirements for a reorganization under I.R.C. § 368(a)(1)(B). A reorganization under I.R.C. § 368(a)(1)(B) is the acquisition by a parent (or subsidiary) of stock of another corporation in exchange "solely for voting stock" of the parent corporation where, immediately after the exchange, the parent corporation (or subsidiary) holds stock in the acquired corporation representing control of the acquired corporation. I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c).

In this case, the taxpayer acquired all of

outstanding stock in exchange solely for its voting stock and, immediately after the exchange, the taxpayer controlled. The fact that the taxpayer paid cash in lieu of issuing fractional shares of stock does not violate the "solely for voting stock" requirement of I.R.C. § 368(a)(1)(B). Mills v. Commissioner, 331 F.2d 321 (1964), reversing 39 T.C. 393 (1962); Rev. Rul. 66-365, 1966-2 CB 116. Thus, the acquisition of Career also satisfied the statutory requirements for a reorganization under I.R.C. § 368(a)(1)(B).

Finally, courts have also imposed three additional requirements for a merger to qualify as a reorganization under I.R.C. § 368. Honbarrier v. Commissioner, 115 T.C. 300, 310 (2000). The three requirements are: (1) business purpose, (2) continuity of business enterprise, and (3) continuity of interest.

The first requirement, continuity of interest, was originally created in <u>Cortland Specialty Co. v. Commissioner</u>, 60 F.2d 937 (2d Cir. 1932), and is now embodied in Treas. Reg. § 1.368-1(b) and described in paragraph (e) of the same section. "Continuity of interest" requires that the original owners of the transferor corporation retain a continuing interest in the reorganized corporation. The requirement was satisfied in this case because ______'s shareholders retained an interest in the reorganized corporation through the taxpayer's stock.

The second requirement, business purpose, was first enunciated in <u>Gregory v. Helvering</u>, 293 U.S. 465 (1935), and is now embodied in Treas. Reg. § 1.368-1(b) and described in paragraph (c) of the same section. "Business purpose" requires that a transaction must be disregarded if the transaction was entered into solely for tax avoidance and served no valid business purpose. In this case, we are aware of no facts that indicate the transaction lacked a valid business purpose.

The third requirement, continuity of business enterprise, was first expressed in Cortland Specialty Co., supra, and is now embodied in Treas. Reg. §§ 1.368-1(b) and described in paragraph (d) of the same section. "Continuity of business enterprise" requires that the acquiring corporation either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business. Honbarrier v. Commissioner, 115 T.C. 300, 311 (2000); Treas. Reg. § 1.368-1(d)(2). The fact that the acquiring corporation is in the same line of business as the acquired corporation tends to establish the requisite continuity, but is not alone sufficient. Treas. Reg. § 1.368-1(d)(3)(i).

In this case, it appears that the continuity of business

nterprise requirement has been satisfied. 's historic
usiness was services (primarily and
ome services). The taxpayer was also in the
business, which tends to establish the requisite
ontinuity. Although disposed of its subsidiaries
ithin years of the acquisition, the taxpayer continued to
rovide and services (in fact, services services)
businesses were merged into one of the taxpayer's
ubsidiaries in).

In light of the above, the acquisition qualifies as a reorganization under I.R.C. § 368(a)(1)(A) by reason of the application of § 368(a)(2)(E), and the acquisition also qualifies as a reorganization under I.R.C. § 368(a)(1)(B).

Issue 2

Treas. Reg. § 1.358-6 provides rules for computing a controlling corporation's basis in the stock of a controlled corporation as the result of certain triangular reorganizations, including reverse triangular mergers, one of the types of mergers. The regulation applies to reorganizations that occurred on or after December 23, 1994. Treas. Reg. §§ 1.358-6(b)(2)(iii), (c)(2)(i), (f).

In the explanation of Treas. Reg. § 1.358-6, the names P, S and T are used. P is defined as a corporation (1) that is a party to a reorganization, (2) that is in control of another party to a reorganization, and (3) whose stock is transferred in the reorganization. Treas. Reg. § 1.358-6(b)(1)(i). S is defined as a corporation (1) that is a party to the reorganization, and (2) that is controlled by P. Treas. Reg. § 1.358-6(b)(1)(ii). T is defined as a corporation that is another party to the reorganization. Treas. Reg. § 1.358-6(b)(1)(iii). In this case, P represents the taxpayer; S represents and T represents

Pursuant to Treas. Reg. § 1.358-6(c)(2)(i)(A), for purposes of computing the taxpayer's basis in the stock acquired as a result of the reverse triangular merger, the basis rules applicable in a forward triangular merger apply. Simply put, such treatment results in the taxpayer having a basis in stock equal to the taxpayer's basis in its stock increased by stock 's net asset basis. Treas. Reg. §§ 1.358-6(c)(1), 1.358-6(c)(4), Examples 2(a)-(b).

However, because this reverse triangular merger also qualifies as a reorganization under I.R.C. § 368(a)(1)(B), the taxpayer has the option of (1) computing its basis in stock using the basis rules for a forward triangular merger

(discussed above) or (2) computing its basis in stock under I.R.C. § 362(b). Treas. Reg. § 1.358-6(c)(2)(ii). Under I.R.C. § 362(b), the taxpayer's basis in stock would be stock would be stock immediately before the merger. I.R.C. § 362(b); Treas. Reg. § 1.358-6(c)(4), Example 2(c).

Finally, where, as in this case, the taxpayer and become members of a consolidated group after the reorganization, Treas. Reg. § 1.358-6(e) references the additional basis rules at Treas. Reg. § 1.1502-30. However, in this case, Treas. Reg. § 1.1502-30 does not apply. Treas. Reg. § 1.1502-30 only applies to (among other things) reverse triangular mergers which do not also qualify as a reorganization under I.R.C. § 368(a)(1)(B), and, in this case, the transaction also qualifies as a reorganization under I.R.C. § 368(a)(1)(B). See Treas. Reg. § 1.1502-30(b)(2).

If you have any questions, please contact the undersigned at (904) 665-1987.

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